ARC PROVIDES HIGHLIGHTS FROM SMITHNOVAK'S VIRTUAL CONFERENCES ON ITALIAN AND GREEK NON-PERFORMING LOANS MARKETS

KEY CONSIDERATIONS

SmithNovak hosted two conferences on Italian and Greek non-performing loans (NPLs) markets in May and June 2021, attracting several representatives from different institutions, including credit rating agencies, regulatory authorities, servicers, investors, banks and law firms. The topics focused mainly on the latest trends and developments characterising the Italian and Greek NPL markets from different angles, including political, sell and buy sides.

- ✓ After years of significant progress in the reduction of NPL ratio, the level of bad loans is expected again to raise over the next few years across Europe. In ARC's view this is especially true for those countries whose economies are relying on hard-hit sectors by the Covid-19 such as tourism and hotels, which are likely to suffer more due to governments measures, such as social distances and travel permissions, imposed to the populations to curb the virus' spread.

- ✓ The effect of the pandemic on the Italian as well as Greek and Cypriot credit systems is yet to be fully realised. ARC sees the political responses to the pandemic, including the success of vaccination campaigns and the resulting lower rates of contagious and hospitalization, playing a key roles in determining how severe the consequences of the crisis resulting from the virus are going to be.

- ✓ Equally decisive will be the choice to leave some supportive measures in place, such as moratoria, acknowledging that a protracted public intervention might inadvertently create a zombification of large swathes of the economy. This would weaken banks and impair the ability to support those activities that have a better chance to grow and create new jobs. In ARC's view, a key exercise will be separating viable from non-viable companies, leaving the former to thrive.

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ITALIAN NPL MARKET

Despite lockdowns, the expected deterioration of the quality of assets on Italian banks' balance sheets has not yet materialized as severely as initially forecast. Borrowers have largely continued to service their debts and in 2020, the non-performing exposures (NPE) stock grew, slightly up compared to 2019.

The reason behind this unexpected NPE trend is explained mainly by the massive recourse to state guaranteed loans as well as moratoria, extended until the end of 2021, which is preventing the borrowers defaulting at a rapid and uncontrolled pace. However, there was consensus among the panellists that once relieved, such measures will reveal their collateral effects, leading to an increase of both non-performing loan and unlikley-to-pay (UTP) levels, thus leaving the system to face old and new issues, especially with regard to the management of UTP.

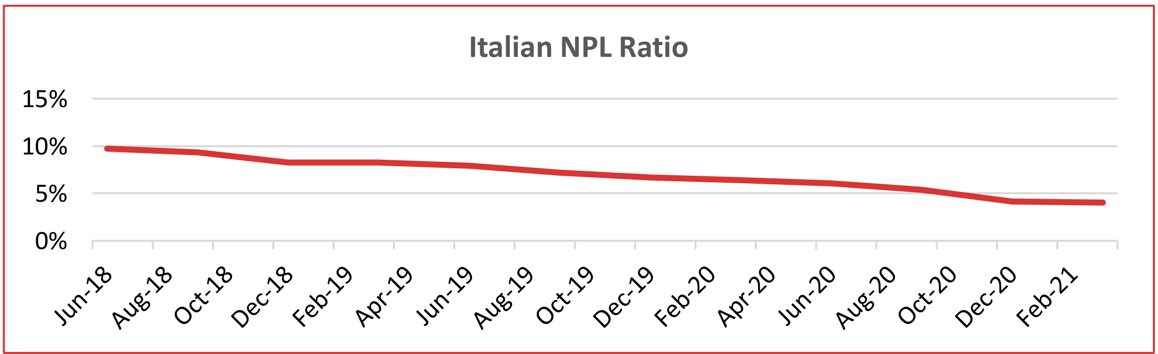
On this subject, one of the main challenges banks, investors and servicers are facing nowadays is represented by the change in skills needed by debt and credit management professionals to manage UTP portfolio. Traditional recovery strategies that worked well with NPLs might not necessarily be suitable for borrowers struggling for the first time to meet their financial obligations. ARC shares this view, noting however that an important and further distinction has to be made when a portfolio of assets has been classified as UTP.

Before the introduction of the new definition of default came into force early this year, due to the intrinsic features of the Italian law on the classification of a loan at different stages of deterioration in the past, it could be the case that some portfolios of UTPs are de-facto NPLs, as some or most of the assets have not been performing for a long period. In this instance, sellers and buyers might find it more challenging to convey what the level of collections achievable by the servicer in charge to execute the recovery strategies is going to be, and therefore the gap between the price asked and bid of a UTP portfolio might be too wide.

Speakers at the events noted that there are certainly additional factors that might slow down the trade of some UTP portfolios, such as various uncommon legal transactions' features – ie lack of reps and warranties – observed on past UTP transactions, which are deemed appropriate to be included in the contracts by the buyers instead.

However, there was consensus among the panellists that the investors' appetite is strong for the Italian market as distressed portfolios are believed to be able to deliver higher returns due to the assets they contain.

The NPL Italian primary market is well developed, and prices seem to be aligning to levels before the pandemic, probably as a result of higher demand from the investors' side combined with a lower offer of distressed assets, given the intense activity of de-risking/portfolio dismissions carried out by the Italian banks since 2016.



Source: EBA Dashboard

From a bank perspective, the Covid-19 impact was relatively limited, not only because Italian banks were in better financial condition compared to a few years previous, but also due to the intervention of the public authorities who provided firms and individuals with the necessary liquidity to mitigate the adverse economic consequences caused by the pandemic.

In addition to this, banks are expected to deal with an expected increasing flow of NPE, starting from 2022, in several ways, ranging from the usual portfolio disposals through securitisations, most probably assisted by the government guarantee scheme, "GACS" (recently renewed until June 2022), sales of loans, transfer of receivables, setting up credit funds, to the implementation of efficient IT systems that raise early warning flags to signal a potential deterioration in a borrowers' creditworthiness in a timely manner. It has been argued that the latter probably came to light also in response to the introduction of the calendar provisioning.

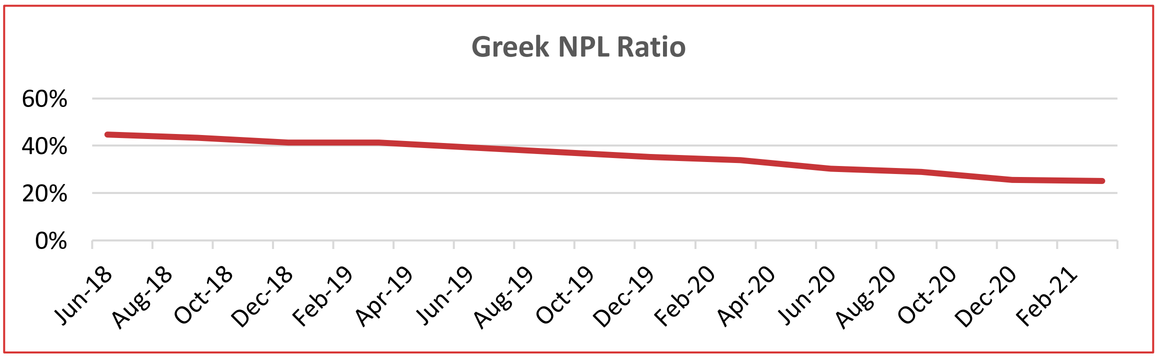
Several panellists suggested the coverage of GACS, limited to NPLs, should be extended further in order to include other distressed assets, such as UTPs. ARC welcomes the idea, and in general, any state intervention which helps banks deal efficiently and effectively with the uncertainty of the markets and increasing riskiness of their portfolio of assets posed by the virus since the beginning of 2020, following the GACS model.

GREEK AND CYPRIOT NPL MARKETS

Similarly, Covid-19 negatively affected the Greek financial system, while the deteriorating economic situation of businesses and households resulting from the pandemic exposes Greek banks to the risk of again making large forecasts on NPLs. This results, as witnessed in 2020, in significant losses totalling Eur 10 billion, according to some of the panellists.

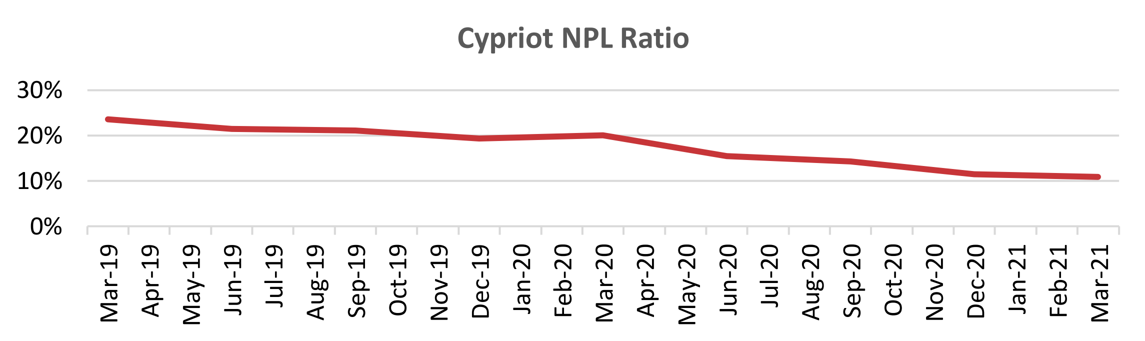
Greece has been taking different actions so far to deal with a growing level of NPLs which has given the country one of the highest levels of NPL ratios in Europe. To control this situation, the government adopted different measures ranging from the possibility of suspending the payment of loan instalments (moratorium), subsidies on loan instalments (Bridge I and II programs), the suspension of debt collection enforcement as well as the approval of the new bankruptcy law which allow both individuals and legal entities either to restructure or to settle their existing debts, having as a prerequisite the liquidation of their personal assets.

The renewal of the Hellenic Asset Protection Scheme ("HAPS") until October 2022 allows several Greek banks to dispose of large NPL portfolios thus ensuring a greater level of financial stability for the country. ARC looks favourably on such extension, noting however that there will be a material pressure to work out an unprecedent number of distressed assets on the servicers. Because of this, authorities' attention will likely shift from banks to servicers, making sure they have the skills and capabilities required to control the situation.



Source: EBA Dashboard

Despite deleveraging efforts from Cypriot banks and measures implemented by the Cypriot government to provide relief to borrowers, the pandemic is likely to result in a new wave of NPLs, which the banks will need to prepare for.



Source: EBA Dashboard

More than has been observed in other countries, the NPL market in Cyprus was affected mostly by the performances of its real estate market, whose lack of liquidity is probably one of the main weaknesses and challenges both servicers and valuators when performing their appraisals. In addition to this, some speakers noticed that the suspension of the nation's Golden Visa programme has undermined the foreign demand of properties, affecting negatively, even further, the local real estate market.

Other initiatives which – partially has been argued - contributed to controlling the level of NPLs include the ESTIA scheme, set up in 2019, and whose purpose is to boost borrowers' ability to repay their loans, as the government subsidizes part of the repayment instalments by a third of the restructured loan. While being a partial positive relief for the people most in need, in ARC's view more needs to be done to take the country on the right path of economic growth.

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